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In the Supreme Court of the United States

No. 628.

OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,
Petitioner,

vs.

MIDLAND-ROSS CORPORATION,
Respondent.

BRIEF FOR RESPONDENT.

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UNITED STATES OF AMERICA,
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vs.

MIDLAND-ROSS CORPORATION,
Respondent.

BRIEF FOR RESPONDENT.

QUESTION PRESENTED.

Whether Congress intended that difference between face value and the price at which an investor purchased a debt obligation from the debtor should be taxed upon realization by sale as capital gain or instead as if it were interest.

STATUTES INVOLVED.

The relevant statutes and regulations are set forth in the appendix, pages 1a-10a, *infra*.

STATEMENT.

Respondent is the successor by merger to Industrial Rayon Corporation (Industrial) (R. 17).¹ During 1952, 1953 and 1954 Industrial, following a long practice (R. 17), used its excess funds to acquire various non-interest bearing corporate notes of the type commonly used for financ-

¹ "R." references are to the Transcript of Record. "Br." references are to the Government's Brief.

ing by General Motors Acceptance Corporation, Commercial Investment Trust Co. and Commercial Credit Co. at less than their face value (i.e., at a discount) (R. 13-15). Each of the notes was sold prior to maturity at a profit which aggregated \$282,763 (R. 13-15). Industrial reported these profits as capital gain, partly long-term and partly short-term (R. 27). The Internal Revenue Service asserted a deficiency on the ground that the profit should be taxed as ordinary income. Industrial paid the applicable tax and instituted this action for its refund.

There is no contention that the discount at which the notes were purchased was, as a factual matter, interest in disguise. On the contrary, it is stipulated that there was no interest (R. 13-15) and that Industrial realized gains from the sale of capital assets (R. 16).

Under the law which has been in effect since December 31, 1954, the profit would be taxed as ordinary income.² However, the transactions involved here occurred prior to the change in the law, so that respondent contends, and the lower courts held, that the profit should be taxed as capital gain.

² Section 1232(a)(2), Internal Revenue Code of 1954. All references to the Internal Revenue Code of 1939 will be cited I. R. C. of 1939. All references to the present Internal Revenue Code (Title 26 U. S. C.) will be cited I. R. C.

SUMMARY OF ARGUMENT.

The narrow issue presented by this case is the tax treatment of the appreciation in value during the period of the taxpayer's ownership of a corporate debt instrument purchased below face value. The general rule is that appreciation in value of an asset due to the passage of time does not result in income until the sale of the asset when the income resulting from such appreciation is taxed at capital gain rates if the statutory requirements are met. The Government here is attempting to establish an exception to this rule in the case of a debt obligation originally issued by the debtor at a price below face value. By the terms of the statutes applicable to the years involved in this case the gain was a capital gain.

Under § 1232 I. R. C. the discount below face value at which a corporate debt is purchased is taxed under specified circumstances as ordinary income when the obligation is sold, but this provision is expressly applicable only to obligations issued after December 31, 1954 and does not apply to this case.³ The Government's attempt to tax this profit as if it were interest is, in effect, an attempt to apply the later statute retroactively.

There is abundant and clear legislative history demonstrating that Congress intended that the discount at which debt obligations are purchased should be reflected only in capital gain or loss at the time of sale. The Senate showed this understanding in 1929 when it enacted a statute requiring a different result for United States obligations. A subcommittee of the House of Representatives showed

³ Although one special type of discount was treated as ordinary income to all taxpayers and all such discount was treated as ordinary income to insurance companies under the Internal Revenue Code of 1939, no such exception applies to this case, and the profit is a capital gain under the statute.

the same clear intention in 1938 when it was considering the general revision of the income tax law which became the Internal Revenue Code of 1939. Again in 1954 when it was considering § 1232 I. R. C. which changed the result prospectively, the Ways and Means Committee of the House of Representatives stated that profit attributable to the purchase of a debt obligation at a discount was taxed at capital gains rates.

Throughout the history of the Internal Revenue laws until 1953 the Treasury agreed with the capital gain result and expressly stated in a number of rulings that the discount at which obligations were originally issued resulted in capital gain at the time of sale. In 1953, shortly prior to the enactment of § 1232 I. R. C., the Internal Revenue Service reversed its position in a ruling which has been severely criticized,⁴ Rev. Rul. 119, 1953-2, Cum. Bull. 95.

The Government's comparison between the purchase of a note for \$100 promising to pay \$100 plus 6% interest and a note promising to pay \$106, both misconstrues the question involved and over-simplifies the problem. The question for the Court to decide is whether Congress intended discount to be taxed differently than interest, not whether discount can in some cases be the financial equivalent of interest or what is the degree of equivalence in any particular case.

Discount is legally indistinguishable from bond premium, which is the amount by which the purchase price of a bond exceeds its face value. Yet this Court itself has established that bond premium is not to be taxed as if it were an interest item, but is rather to be reflected in capital gain or loss at the time of sale. To reach a contrary

⁴ Janin, *The Israeli Bond Ruling: Legislation By Administrative Fiat?*, 33 Taxes 191 (1955).

result with respect to discount would be unjustified in the absence of legislative authority such as that contained in § 1232 I. R. C. applicable to years subsequent to 1954. Other points raised by the Government are incorrect or irrelevant as demonstrated in "Argument" below. While Courts of Appeals other than the Sixth Circuit have upheld the result for which the Government contends, they have done so without the benefit of the extensive legislative and administrative history available, and without considering this Court's decisions establishing that the purchase of a bond for a premium is reflected only in capital gain or loss at the time of sale. The absence of any discussion in the opinions in these cases of these directly relevant materials makes them completely unpersuasive. The only court which has considered the relevant material is the District Court below, 214 F. Supp. 631 R. 18 (N. D. Ohio 1963), aff'd on the opinion below, 335 F. 2d 561 (6th Cir. 1964), which concluded in an extensive opinion that it was the clear intent of Congress that the gain involved here be taxed at capital gain rates.

In conclusion we submit that the Government asks this Court to legislate with respect to a period which Congress chose not to cover and in a manner different than Congress established for the future.

ARGUMENT.

I. PLAINTIFF IS ENTITLED TO A REFUND BECAUSE THE REALIZATION OF THE DISCOUNT AT WHICH A PRIVATE DEBT OBLIGATION IS ISSUED IS CAPITAL GAIN UNDER THE APPLICABLE 1939 INTERNAL REVENUE CODE PROVISIONS INTERPRETED IN ACCORDANCE WITH THEIR LEGISLATIVE HISTORY AND ADMINISTRATIVE CONSTRUCTION.

As a general rule, if the value of a capital asset increases due to the passage of time, no income results unless and until reflected in gain when the property is sold, and such gain is normally capital gain. This general rule is not altered by the fact that such increase in value may sometimes as a financial matter be similar to interest, as in the case of debt discount. Just last month the Treasury reaffirmed its longstanding position that a discount for advance payment of insurance premiums at a compound rate of three percent per annum is not interest, but merely reduces the cost of the policy.⁵ Similarly, where stockholders buying stock on a rights offering are allowed a discount at the rate of six percent per annum in return for paying for the stock before it is issued, the discount is not interest, but a lessening of cost ultimately to be reflected in gain if the stock is sold.⁶

The Government seeks here to carve a narrow exception out of this well-established rule. It contends that when a debt instrument is purchased by an investor from the issuer at a discount below face value, the discount should

⁵ Rev. Rul. 65-24 I. R. B. 1965-6, p. 5, reaffirming I. T. 3513, 1941-2 Cum. Bull. 75.

⁶ *Baltimore & Ohio R. R. Co. v. Commissioner*, 78 F. 2d 460 (4th Cir. 1935).

be taxed as if it were interest.⁷ The applicable sections of the Internal Revenue Code of 1939, however, call for the opposite result.

The applicable Code provision in plain terms stated that: "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis." Section 111(a) I. R. C. of 1939. If the asset is a capital asset, as has been stipulated here (R. 16), the "gain from the sale" is specially taxed either as long term or short term capital gain depending upon the holding period.⁸ Section 117 I. R. C. of 1939.

Pursuant to these explicit provisions the taxpayer in its returns for 1952, 1953 and 1954 reported its gains from the sales of these notes as capital gain. Prior to the proposal for a change in these provisions in the Internal Revenue Code of 1954, we believe the Internal Revenue Service would not have questioned this treatment.

In adopting the revised 1954 Code Congress for the first time made explicit provision for corporate notes issued at a price less than their face amount. This new 1954 Code Section 1232 was applicable to the taxpayer's 1954 return, though not its 1952 and 1953 returns, and provided (as detailed below, pp. 31-32) that gain upon the sale of notes issued at more than a limited discount "shall be considered as gain from the sale or exchange of property which is not a capital asset," and hence not entitled to the special capital gain tax limitation, but only with respect to "bonds or other evidences of indebtedness issued after

⁷ No showing that the discount at which the various notes involved here were purchased was the same as interest would have been has been made in this case. It has been stipulated that a number of factors common to all investments in debt securities influenced the purchase price. R. 16.

⁸ Both long term gain (R. 13-15) and short term gain (R. 14) are involved here.

December 31, 1954" (1954 Code Section 1232(a)(2) (A)). Thus the treatment of these gains reported in taxpayer's 1954 return did not differ from that under the 1939 Code.

The reasons which led the Internal Revenue Service to recommend to Congress that the Code be changed to provide that original issue discount when realized on sale should not be entitled to capital gain treatment, and which persuaded Congress so to provide with respect to evidences of indebtedness issued after December 31, 1954, were presumably those so forcefully presented in the Government's brief in this case. Presumably also, those same reasons also led the Internal Revenue Service to attempt to apply this new statutory provision retroactively and to assess tax on the taxpayer's profits from the notes as though they were ordinary income, not capital gain. Upon action by this taxpayer to secure a refund of the resulting tax which it paid, District Judge Kalbfleisch, with the unanimous concurrence of the Court of Appeals for the Sixth Circuit (R-35), held that Sections 117 and 111 of the 1939 Code required capital gain treatment of the taxpayer's profits, and that 1954 Code, Section 1232 was applicable only prospectively with respect to notes issued after December 31, 1954 and was not, as the Government now contends, declaratory of prior law.

The House Ways and Means Committee, which wrote the 1954 Code, could not more clearly have denied the Government's proposition:

"Under existing law any gain realized from a corporate or Government bond in registered form or with coupons attached is treated as a capital gain either if the bond is held to retirement or, it is sold or exchanged. Part or all of this gain, however, may represent discount on original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.

"Effective with respect to bonds issued after December 31, 1954, the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income." H. Rep. No. 1337, 83rd Cong., 2d Sess. p. 83 (1954).⁹

The 1939 Code had earlier included one statutory exception treating a particular type of original issue discount as ordinary income to all taxpayers and another treating all such discount as ordinary income to a particular type of taxpayer, but neither of these exceptions apply here:

(a). Section 117(a)(1)(D) I. R. C. of 1939 specifically excepted from the definition of capital assets:

"(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Had this section not been limited to governmental obligations, it would have been directly applicable to the case at bar and would have required the result sought by the Government here without benefit of further legislation. It is noteworthy that this section refers to obligations issued "on a discount basis and payable without interest." There could hardly be a more conclusive demonstration that Congress recognized, as does the Government (Br. 12), the traditional usage of "discount" and "interest" as separate and distinct items, and that prior to 1954 Congress did not intend that discount on nongovernmental

⁹ The Senate Finance Committee report on the 1954 Code was not thus explicit with respect to the prior law.

debt obligations should be deprived of capital gain treatment.

(b). Section 207(d) I. R. C. of 1939 provided as to certain insurance companies:

"The gross amount of income * * * from interest * * * shall be * * * increased by the appropriate accrual of discount attributable to the taxable year on bonds * * * " ¹⁰

The applicable Regulations stated affirmatively that the taxation of discount to insurance companies as interest required by this special provision was different from the treatment of other corporations.¹¹

Although other Regulations under the 1939 Code spelled out in vast detail various types of income, they never even implied that the discount at which debt obligations were originally purchased should be taxed to the holder of the obligations as if it were interest.¹²

It should thus be clear as a matter of interpretation of the statute and Regulations that the gain involved here was capital gain even without the support of legislative history and administrative practice. Any remaining doubt, however, is removed by examining these materials.

¹⁰ Section 207 I. R. C. of 1939 dealt with mutual insurance companies other than life or marine. Section 201(e) I. R. C. of 1939 contains a similar requirement applicable to life insurance companies.

¹¹ Reg. 39.207-1(a)(2) states: "The taxable income of mutual insurance companies subject to the tax imposed by section 207 differs of the taxable income from other corporations. * * * The gross amount of income during the taxable year from interest * * * [is] decreased by the appropriate amortization of premiums and increased by the appropriate accrual of discount * * *"

¹² The Commissioner for many years treated this gain as capital gain. pp. 12-14, *infra*. After he had changed his position in 1953 and after the enactment of § 1232 I. R. C. in 1954 a provision was inserted in the Regulations adopting the new theory. Reg. 1.61-7(c).

The legislative history is most helpful. Both houses of Congress have unequivocally stated their view that the gain attributable to debt securities purchased at a discount is a capital gain. In the Senate a 1929 debate on a proposal to exempt United States discount obligations from this capital gain clearly shows that it was understood that, even though discount could be financially equivalent to interest, it would be taxed as capital gain—undoubtedly, in part because Undersecretary of the Treasury, Ogden Mills, so informed the Senate Finance Committee.¹³ The District Court below, the first court considering the problem which seems to have been aware of this debate, stated as to it “* * * [this] legislative history indicates that appreciation resulting from this discount [on Federal Government bonds] was statutorily transferred into interest to avoid its taxation as capital gain.” 214 F. Supp., at 636, R. 26. The full text of this debate is reproduced in the appendix.

Similarly, in 1938 a Subcommittee of the House Ways and Means Committee stated, in a report that resulted in the Internal Revenue Code of 1939, flatly that “A bond purchased at a premium results in capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain.” Appendix, p. 11a. This was followed in 1954 by the Ways and Means Committee’s unqualified statement, quoted at pp. 8-9 above, that “existing law,” the law in effect for the years here involved, treated gain from the obligations specified as capital gain even though it in-

¹³ Senator Couzens of Michigan stated: “The Undersecretary of the Treasury stated before the Finance Committee that the same identical bills of indebtedness, when traded in commerce, are subject to a profit tax. When a bill is traded in commerce, an acceptance, or what not, if there is a capital gain, it is taxed.” June 4, 1929, Congressional Record, Senate, p. 2330.

cluded "discount on original issue." H. Rep. No. 1337, 83rd Cong., 2d Sess. p. 83 (1954).

Further confirmation of the legislative intent in enacting and re-enacting the 1939 Code is supplied by the numerous special provisions therein relating to other circumstances not directly involved here, both in regard to bond discount and its twin, bond premium¹⁴—enactments which would have been largely superfluous if the Government's present contentions represented the accepted law.¹⁵ In fact, the understanding was so clear that H. R. 6999 was introduced in 1948 to tax the profit on United States Savings Bonds at capital gain rates so that they would have the same advantages as private bonds.¹⁶

It seemed apparent that the Treasury agreed that the realization of original issue discount resulted in capital gain, until about 1953 when the statute which changed this result prospectively was being drafted. The regulations dealing with insurance companies (see n. 10, *supra*), so indicated, and the Treasury many times ruled specifically that the realization of discount was capital gain. Contrary to the Government's contentions, these rulings were not all in the early history of the tax law. In 1952, only a year prior to the Treasury's change of position, it issued a private ruling stating, not only that discount should not be

¹⁴ See discussion of the treatment of bond premium. pp. 18-21 *infra*.

¹⁵ Section 117(a) (1) (D), p. 9 *supra*; Section 201(e), p. 10, n. 11, *supra*; Section 207(d), p. 10 above; Section 42(b), allowing an election to taxpayers to report increases in the value of certain discount obligations annually; Section 42(c), providing that income from short term government discount obligations should not be taken into account until disposition of the obligations; Section 125, providing an election to amortize bond premium; Section 113(b) (1) (H), providing a reduction in basis for amortized bond premium.

¹⁶ Appendix, *infra*. The background for the introduction of this Bill is given in 26 *Taxes* 775 (1948).

treated as interest for the purposes of the withholding tax on nonresident aliens, but also that if such discount was taxable at all to nonresident aliens it was taxable under the section of the law dealing with capital gains.¹⁷ Similarly, in 1948 a private ruling was issued holding that discount on private bonds resulted in capital gain and explaining the statutory distinction which made the discount on Government bonds taxable as ordinary income.¹⁸ Since private rulings are not generally reported, undoubtedly these rulings are only two of a number which were issued prior to the change of position in 1953. Cf. *Flora v. United States*, 357 U. S. 63, on rehearing 362 U. S. 145.

In 1920¹⁹—and in part again in 1922²⁰—the Treasury held that such discount was not interest, should be reflected in gain or loss at the time of sale, and should not be treated as interest for withholding purposes. In 1927 the Treasury's then position was formally and vigorously presented to the Board of Tax Appeals, where it was upheld.²¹ In 1929, as we have seen, the Undersecretary of the Treasury informed the Senate Finance Committee of this capital gain treatment. The last formal announcement of this position prior to the private rulings was the 1944 acquiescence in *Commissioner v. Caulkins*, 144 F. 2d 482 (6th Cir.,

¹⁷ 5 CCH 1952, Stand. Fed. Tax Rep. par. 6161. The meaning of this ruling is not clear without reference to § 211 (a) (1) (B), I. R. C. of 1939 (dealing with capital gains of aliens) and to the request for the ruling published at 5 CCH 1952, Stand. Fed. Tax Rep. par. 6284, all of which are reproduced in the Appendix.

¹⁸ An extract from this Ruling was published at 26 Taxes 775 and is reproduced in the Appendix.

¹⁹ O. 1024, 2 Cum. Bull. 189 (1920), O. D. 475, 2 Cum. Bull. 211 (1920).

²⁰ I. T. 1398, 1-2 Cum. Bull. 149 (1922).

²¹ *Corn Exchange Bank v. Commissioner*, 6 B. T. A. 158 (1927).

1944),²² which had held that discount, when realized on the retirement of a non-interest bearing obligation, was capital gain.

The change of position in 1953²³ can hardly blunt the force of this record. As the court said in *Bliss v. Commissioner*, 68 F. 2d 890, 893 (2d Cir.) aff'd *sub nom. Helvering v. Bliss*, 293 U. S. 144 (1934):

"The consistent administrative rulings of the commissioner from 1923 to 1932, during which time the provisions in question were thrice re-enacted, may properly be given weight by the courts. *Brewster v. Gage*, 280 U. S. 327, 336, 50 S. Ct. 115, 74 L. Ed. 457. We do not think that the commissioner's subsequent about-face renders the principle inapplicable."²⁴

The principle is equally applicable to private rulings. In *Hanover Bank v. Commissioner*, 369 U. S. 672 (1962), this Court said:

"Furthermore, although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, [footnote omitted] such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws. And, because the Commissioner ruled, in letters addressed to taxpayers requesting them, that amortization with reference to a special call price was proper under the statute, [footnote omitted] we have further evidence that our construction of allowable bond premium amortization is

²² The Treasury acquiesces only in adverse Tax Court decisions and therefore technically the acquiescence was in the decision in the Tax Court, 1 T. C. 656 (1943), which the Sixth Circuit affirmed, 1944 Cum. Bull. 5.

²³ The change was first officially announced in Rev. Rul. 119, 1953-2 Cum. Bull. 95. Although the acquiescence was not withdrawn until 1955 (Rev. Rul. 55-136, 1955-1 Cum. Bull. 213); Rev. Rul. 119 limited the *Caulkins* case to its precise facts.

²⁴ Emphasis supplied throughout unless other indicated.

compelled by the language of the statute. [Footnote omitted]" 369 U. S. at 686-687.

Against this array of authority the Government relies almost entirely upon an over-simplified example and a series of three analogies which, upon examination, do not support its case.

II.

THE DEFENDANT'S THEORIES AND ARGUMENTS ARE WITHOUT MERIT.

Prior to discussing the theories upon which the Government does rely it is worth noting the authorities upon which it seems to place no great reliance. Beyond the cases pending in this Court, there are decisions by three Courts of Appeal,²⁵ the Court of Claims²⁶ and the Tax Court²⁷ apparently sustaining the Government's position. But none of these Courts came to grips with the real question involved, relying primarily instead on cases which the Government does not even cite.²⁸

²⁵ *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir. 1959); *Rosen v. United States*, 288 F. 2d 658 (3d Cir. 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Cir.), cert. denied 372 U. S. 934 (1963).

²⁶ *Pattiz v. United States*, 311 F. 2d 947 (Ct. Cl. 1963).

²⁷ *Gibbons v. Commissioner*, 37 T. C. 569 (1961); *Schwartz v. Commissioner*, 40 T. C. 191 (1963).

²⁸ These courts relied principally on the principle that the sale of an ordinary income item does not convert it to a capital gain without examining whether they were dealing with an ordinary income item. Cf. *Rosen v. United States*, *supra*, which alone contains a superficial discussion of the real issue. For this principle the cases largely relied on *United States v. Snow*, 223 F. 2d 103 (9th Cir. 1955), cert. denied 350 U. S. 831; *Helvering v. Horst*, 311 U. S. 112; *Tunnell v. United States*, 259 F. 2d 916 (3d Cir. 1958) and *Hort v. Commissioner*, 313 U. S. 28, none of which are cited by the Government, as well as *Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260; *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir. 1954) and *Commissioner v. Phillips*, 275 F. 2d 33 (4th Cir. 1960) which the Government does cite.

It cannot be denied that as a matter of numbers the Second Circuit, in *Dixon*, 333 F. 2d 1016, pending on petition for writ of certiorari, No. 486, this term, has more support than the Sixth Circuit in the case at bar, but at the same time it cannot be overemphasized that this is a matter of numbers only. Examination of the briefs in the cases decided by the other Circuit Courts and the Court of Claims reveals that they were not informed of the published rulings of the Treasury in 1920²⁹ and 1922, the Senate debate in 1929, the House of Representatives Subcommittee Report in 1938, the unpublished rulings in 1948 and 1952, the decisions of this Court dealing with bond premium³⁰ and the Tax Court's decision in the *Corn Exchange Bank* case.

Understandably, the Government virtually ignores the decisions exhibiting such a massive lack of information and seeks instead to support its case with irrelevant and inapplicable materials. This will not do. Its case must stand or fall on this unreasoned authority, for it has no other.

²⁹ One of these rulings (O. 1024, 2 Cum. Bull. 189 (1920)) was cited by the taxpayer in *United States v. Harrison*, 304 F. 2d 835 (5th Cir. 1962), cert. denied 372 U. S. 934.

³⁰ One of the four decisions, *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, was cited for a different point by the Government in *Pattiz v. United States*, 311 F. 2d 947 (Ct. Cl. 1963), and *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir. 1959) and by both parties in *Rosen v. United States*, 288 F. 2d 658 (3d Cir. 1961).

1. The Government's Example Both Misconstrues the Question Involved and Oversimplifies the Question to Which It Is Addressed, as Evidenced by Established Law as to Bond Premium.

The Government's principal argument is that a \$100 note with 6% interest is financially equivalent to the purchase of a \$106 note for \$100. This example would be relevant here only if the question involved were the degree of similarity between discount and interest. But this is not the question presented. The question is whether Congress intended discount to be taxed as if it were interest.

The Government's example has been unrealistically constructed, so that (putting aside prepayment and default situations, bankruptcy, priorities, usury statutes and creditors' rights)³¹ the discount involved is the exact financial equivalent of the interest with the result that there is a formal difference only. Even conceding, for this purpose, that the difference is largely a formal one, the Government's argument must fail, for formal differences are often determinative in this intricate area of the tax law. For instance, for many years very substantial differences in tax treatment have depended upon whether a debt instrument

³¹ Substantial differences exist in these areas. Section 63(a) of the Bankruptcy Act (11 U. S. C. § 103(a)) provides that non-interest-bearing debts not due at the date of bankruptcy must suffer "rebate of interest" which is at the legal rate. *Collier on Bankruptcy* Par. 63.16, pp. 1856-7 (14th ed.). See *In re Orne*, Fed. Cas. No. 10,581 (S. D. N. Y. 1867); cf. *Illinois Steel Co. v. O'Donnell*, 156 Ill. 624, 41 N. E. 185, 186 (1895) where a "just and equitable" rebate was required. On the other hand interest-bearing obligations simply bear no interest after the filing date. Thus where the interest-bearing note bears a rate less than the legal rate a discount obligation will be at a disadvantage in bankruptcy. Similarly, usury statutes are held not to prevent a discount at the full legal rate even though a "yield" in financial terms exceeds the legal rate. 2 *Restatement of Contracts*, Section 534(a) (1932); 6 *Williston on Contracts*, Section 1695, p. 4797 (Rev. Ed. 1938).

was in registered form³² and the Treasury itself insisted prior to the 1964 Revenue Act that in the case of discount obligations issued for property even the mere "name" (Br. 13) given to the payments is decisive,³³ an interpretation which Congress specifically approved. In discussing the provision which became Section 483 I. R. C. the Ways and Means Committee stated in 1963, "This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments."³⁴

Despite a profusion of different examples expressing a payment of \$100 in return for a promise to repay \$106 in a year's time, the Government neglects to mention one situation which makes the point well. A bond purchased for \$100 promising to pay \$94 plus \$12 interest in a year would also be financially equivalent to the Government's example. Yet it is clear, where the obligation is purchased at more than par—at a premium—that the tax result, in the absence of a statutory election, would be a capital loss of \$6 and interest income of \$12.³⁵ If the taxation of investment securities is to be determined by simple illustrations purporting to show economic equivalence, the result in this situation should simply be \$6 of interest income and no capital loss. But settled law, including several

³² Section 117(f) I. R. C. of 1939, which provided that a retirement should be treated as a sale or exchange, was limited in its application to corporate obligations which either were registered or bore interest coupons. Section 165(g) I. R. C. similarly limits losses from worthless securities to such debt instruments. Section 125 I. R. C. of 1939 also limited amortization of bond premium to such instruments.

³³ I. T. 2674, XII-1 Cum. Bull. 96, 97 (1933).

³⁴ H. Rep. No. 749, 88th Cong., 1st Sess., p. 72 (1963).

³⁵ *New York Life Insurance Co. v. Edwards*, 271 U. S. 109. Under § 171 I. R. C. and its predecessors the taxpayer is now permitted to elect to amortize bond premium.

decisions of this Court,³⁶ requires the capital loss result, and refutes the Government's illustration.

The premium and discount situations are legally indistinguishable. The question in both cases is whether the difference between the purchase price and the face value of a debt obligation was intended by Congress to be taxed as if it were interest, instead of being reflected in gain or loss at the time of sale.

Obviously it would require most specific statutory language to compel tax results for purchases of bonds above face value different from those for purchases below face value. In fact there was no suggestion of such a difference, either to the issuing corporation or the investor, until the Treasury changed its position on the question involved here in 1953. On the contrary, the General Counsel of the Bureau of Internal Revenue had said in an official ruling: "It seems obvious that the treatment of premium is analogous to that of discount, and, therefore, the Bureau rulings on the treatment of discount are in point." G. C. M. 1455, VI-1 Cum. Bull. 87, 88 (1927). And one of the first rulings holding that original issue discount affected only capital cost of the obligation explicitly stated that the tax treatment of both *premium and discount* allowed to the issuing corporation could not be used for either by the investor. O. D. 475, 2 Cum. Bull. 211 (1920).

This Court first rejected the arguments the Government makes here in a case involving premiums in *New York Life Insurance Co. v. Edwards*, 271 U. S. 109. The taxpayer in that case attempted to reduce the interest it received on bonds purchased at a premium by the appro-

³⁶ *New York Life Insurance Co. v. Edwards*, *supra*; *Old Colony R. Co. v. Commissioner*, 284 U. S. 552; *Commissioner v. Korell*, 339 U. S. 619; *Hanover Bank v. Commissioner*, 369 U. S. 672. Acc. Rev. Rul: 55-641, 1955-2 Cum. Bull. 294.

priate amortization of the premium, arguing that the bonds were financially equivalent to a lower priced bond with a lower interest rate. The Court held that the premium could not be amortized and that the loss was allowable only upon the sale or other disposition of the obligations.³⁷

When Congress chose in 1942 to authorize an election to amortize debt premium as a reduction of interest income, it made careful and explicit provisions as to the exact circumstances where this would be permitted, as it had done in the case of short-term government discount bonds and in the case of insurance companies. The election under Section 125 I. R. C. of 1939 was limited to evidences of indebtedness (i) issued by a corporation (including government or political subdivision), (ii) bearing

³⁷ In *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, the Court considered essentially the same argument which the Government makes here, as follows (pp. 558-59):

"The conclusion is that the actual return to one who pays a premium is less than the nominal interest carried by the bond, and to one who buys at a discount is greater than such nominal rate. The argument is that although the regulations are inaptly phrased and are susceptible of the construction petitioner places upon them their real intent was to adjust the nominal interest paid on a corporation's indebtedness to the actual amount it is paying for the use of the money represented by the par of the bond,—that is, to what accountants have called the 'effective rate' of interest."

The Court rejected this argument, saying (p. 561):

"We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountants' phrase 'effective rate' of interest and intended that as the measure of the permitted deduction."

Following the 1942 statutory authorization for an investor to elect to amortize bond premium (Section 125 I. R. C. of 1939), this Court held in *Commissioner v. Korell*, 339 U. S. 619 that a premium paid for a conversion privilege was amortizable on the theory that there was no warrant for distinguishing among different reasons for the payment of premium. See also *Hanover Bank v. Commissioner*, 369 U. S. 672.

interest, and (iii) with interest coupons or in registered form, and (iv) explicit exclusions are made with respect to dealers. Further, Congress was careful to make a correlative provision with respect to the adjustment of the basis of the debt obligation, adding subparagraph (H) to 1939 Code Section 113(b) (1).

It required this specific and detailed legislation to permit the treatment of bond premium as an offset to interest. Yet the Government asks this Court to hold that discount can be similarly treated in the face of a deliberate refusal by Congress so to legislate under the Internal Revenue Code of 1939.

2. The Government Wrongly Ignores the History of Treatment of Bond Discount to the Investor as Capital Gain Prior to the Treasury's Change of Position.

The Government states that discount has historically been taxed as if it were interest and then argues that it is permissible to ignore all directly relevant materials prior to 1953 because, it says, it was not decided until that year that the proceeds of the sale of a bond with stated interest could be allocated in part to interest and taxed as ordinary income (Br. 24-25, 31-32). For this reason it argues that we must look to analogous areas to decide this case and relies on three purported analogies, hereinafter considered, instead of discussing the directly relevant authorities.

This argument, however, cannot stand in the face of settled history on the taxation of the sale of interest bearing bonds together with the accrued interest. The tax consequences of bond sales between interest dates, amounting to millions of dollars each day, were certainly known prior to 1953. The obvious allocation was originally required in 1920, Sol. Op. 46, 3 Cum. Bull. 90, and by 1938 the Treasury could state with confidence, "It is

well settled, therefore, that where bonds are sold between interest dates the accrued bond interest to the date of sale is taxable to the person who sells the bonds," I. T. 3175, 1938-1 Cum. Bull. 200, 201. This principle has never been challenged before or since. The sole dispute was in the treatment of bonds in default which were sold "flat."³⁸ Under these circumstances, if the contention that the court need consider only post-1953 materials had any validity in the first place, it falls with its premise.

A further obstacle to the Government's contention that the court need consider direct authorities only if they were decided after 1953 is that for the period from 1944 to 1955³⁹ the Treasury acquiesced in the decision in *Commissioner v. Caulkins*, 1 T. C. 656, aff'd. 144 F. 2d 482 (6th Cir. 1944) that discount realized on the retirement of a debt obligation resulted in capital gain. Both courts below cited this case as authority for their decisions, and for the proposition that discount when realized properly constitutes only capital gain or loss. The Government meets this obstacle by interpreting the acquiescence in the *Caulkins* case as resting solely on the fact that a retirement rather than a sale was involved. Stripped of its verbiage, the Government would have us believe: that the Sixth Circuit Court of Appeals was "plainly mistaken" (Br. 27) and committed an "obvious error" (Br. 28) in *Caulkins* with-

³⁸ See Br. 29 n. 20, 8 n. 2. The Government cites *Jaglom v. Commissioner*, 303 F. 2d 847 (2d Cir. 1962); *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir.), cert. denied 347 U. S. 1014 (1954), *United States v. Langston*, 308 F. 2d 729 (5th Cir. 1962); and *First Ky. Co. v. Gray*, 309 F. 2d 845 (6th Cir. 1962), all of which involved defaulted bonds sold flat. It also cites *Arnfeld v. United States*, 163 F. Supp. 865 (Ct. Cl. 1958), cert. denied 359 U. S. 943; and *Commissioner v. Phillips*, 275 F. 2d 33 (4th Cir. 1960) which involved the wholly different issue of the tax treatment of insurance and annuity policies.

³⁹ Acquiescence 1944 Cum. Bull. 5, withdrawn Rev. Rul. 55-136, 1955-1 Cum. Bull. 213.

out even reaching the question involved here; that the Treasury was sufficiently ignorant of the tax law to acquiesce in this "obvious error" for over ten years;⁴⁰ that the Court in *Caulkins* held that discount is interest (Br. 27) even though it did not reach that question; and finally that the Sixth Circuit in the case at bar, which involved a sale—the purported distinguishing feature—misinterpreted its prior decision in *Caulkins*. The resort to an interpretation involving such a series of unlikely assumptions reveals the weakness of the Government's case.

But the Treasury's action is the best evidence that the assumptions are unfounded. Its acquiescence was in the Tax Court decision, 1 T. C. 656, the holding in which that the obligations were "within the capital gains provision unless expressly excluded," (*id* at 662) must have been clear to the Treasury, and should therefore be obvious to the Government here.

Even if the *Caulkins* case stood alone, therefore, the Government's explanation of it would not hold up under examination. But *Caulkins* does not stand alone. Something of a pattern is established by acquiescences in 1942 and 1944 in decisions in two other cases holding that discount gain was not interest for personal holding company purposes⁴¹—neither case involving the application of § 117 (f). And in *Caulkins* itself in the Tax Court the Government's attorney in effect refuted the Government's current interpretation by conceding that United States Savings Bonds would yield capital gain in the absence of a specific

⁴⁰ In cases where the Treasury agrees with the result of a case but not with its implication it acquiesces "in result only." See e.g., *Brink, et al. v. Commissioner*, 42 B. T. A. 765, acq. as to result only, 1944 Cum. Bull. 4.

⁴¹ *Western Acceptance Corporation v. Commissioner*, 46 B. T. A. 828, acq. 1942-2 Cum. Bull. 19; *Elk Discount Corporation v. Commissioner*, 4 T. C. 196, acq. 1944 Cum. Bull. 8.

statute;⁴² a view reaffirmed only a few years later in a private ruling (26 Taxes 775 (1948) Appendix 33a).

Putting all these elements together there is no remaining doubt as to the holding of the *Caulkins* case and meaning of the acquiescence in it. The plain facts are that in 1944 the Tax Court and Sixth Circuit held that the realization of the discount at which a debt obligation was purchased was capital gain, and the Treasury agreed, at least until 1953.⁴³

3. The Government's Reliance on the Deductibility of Discount by the Issuing Corporation as Analogous Authority is Without Merit Since Many Deductible Payments Are Not Ordinary Income to the Payee.

The Government cites, as virtually its only authority, cases holding that discount and commissions on the sale of bonds are deductible to the issuer over the life of the bonds (Br. 14-16). These cases can be of no aid to a decision here since it is clearly established that the issuer and the investor are not treated alike.

It should be obvious that the Government's argument proves too much from its citation (Br. 15) of *Helvering v. Union Pacific Co.*, 293 U. S. 282. This decision did not involve discount at all, but solely commissions paid to brokers for their services in selling bonds. Obviously the fact that the issuer can deduct these payments over the life of bonds has no effect on the income of the bondholder.

This principle is readily apparent where a securities dealer purchases securities from an investor, where a

⁴² 1 T. C. 656, 662.

⁴³ In 1953 the acquiescence was limited to the precise facts of the *Caulkins* case by Rev. Rul. 119, 1953-2 Cum. Bull. 95. The ruling held that bonds of the State of Israel, similar to United States Savings Bonds, yielded ordinary income rather than capital gain when redeemed. See Janin, *The Israeli Bond Ruling: Legislation by Administrative Fiat?*, 33 Taxes 191 (1955).

manufacturer purchases a building or equipment from a prior owner, where a corporation purchases supplies such as timber and coal from a landowner, where a patent is purchased from an inventor, and in many other cases. Such expenditures as well as the discount at which debt obligations are issued, are costs to the payor and, of course, result in deductions by it from ordinary income. But this deduction does not affect the capital gain treatment of the payments.

The converse of the bond discount case is the receipt of a premium on the issuance of bonds, where it is clear that the issuer has ordinary income (Reg. 1.61-12(c) (2)) and the investor has a capital loss (Rev. Rul. 55-641, 1955-2 Cum. Bull. 294) if the statutory election is inapplicable.

The Treasury itself has pointed out that the different parties are not to be treated alike in O. D. 475, 2 Cum. Bull. 211 (1920) which held that the amortization of premium and discount allowed to the issuer was not available to investors. Furthermore, the deduction for discount is properly allowable to the issuer as a loss and not, as the Government would imply, as interest.⁴⁴

⁴⁴ Mertens states: "Bond discount is founded upon the concept of compensation for a prospective loss." 2 Mertens *Law of Federal Income Taxation*, § 42.109 Ch. 12, p. 345; Molloy, *The Ambiguous Tax Nature of the Various Costs of Borrowing Capital*, 11 *Tax Law Review*, 373, 399-400 (1956), concludes that the weight of authority is that the deduction is allowed as a loss.

Where the distinction between a loss deduction and an interest deduction has been critical, the Treasury has been successful in requiring loss treatment. See, e.g., *Atlanta & Charlotte Air Line Ry. Co. v. Commissioner*, 36 B. T. A. 558, 561, acq. 1937-2 Cum. Bull. 2, which stated:

"The Commissioner regards bond discount primarily as a loss.

* * * * *

These regulations are interpreted by the Supreme Court as classifying discount as a loss sustained on payment of the bonds at maturity. *Helvering v. Union Pacific R. Co.*, 293 U. S. 282."

4. The Government's Reliance on the Taxation of Municipal Bonds as Analogous Authority Is Without Merit.

The Government cites as an analogy favoring it the taxation of the discount at which municipal or state bonds were issued. The rulings cited by the Government, and many others, were all specifically and clearly limited to the exemption from tax of income or gain, rather than dealing generally with the question whether discount is to be taxed as if it were interest.⁴⁵ As the District Court observed, 214 F. Supp. at 636 (R. 25), it is obvious from this limitation that constitutional considerations played a decisive role.

In 1931, in a case deciding that capital gains (other than discount) on state bonds could be taxed, the constitutional theory was stated by this Court as follows:

"In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from federal taxation is the principal and interest of the obligations. *Pollock v. Farmers' Loan & Trust Company*, *supra*. These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the government." *Willcuts v. Bunn*, 282 U. S. 216, 226.

Under this theory any amount promised by a state was exempt, whether principal, discount or interest. It is

⁴⁵ The clear implication of these rulings was, in fact, that in the absence of constitutional considerations the gain was a capital gain. G. C. M. 1455, VI-1 Cum. Bull. 87, 89 (1927) stated: "The amount for which the bonds are purchased without regard to any discount or premium element therein is to be taken as the

(Continued on following page)

not significant therefore that discount on state obligations was taxed in the same way as interest.⁴⁰ It could be argued with equal force that it was taxed in the same way as principal.

5. The Government's Reliance on Purported Accrual to an Accrual Basis Taxpayer as Analogous Authority Is Without Merit.

The final alleged analogy upon which the Government relies is the purported accrualability of discount as income to an accrual basis taxpayer. The Government contends that such an accrual is required (Br. 37-39), but this surely is not, and never was, the law. Only last year, in connection with statutory changes in the taxation of insurance companies, the Senate Finance Committee stated:

"Stock fire and casualty insurance companies on the other hand, and corporations generally, are not required to accrue discount (either that arising at the time of issue or market) on bonds purchased at a discount by them." S. Rep. No. 830, 88th Cong., 2d Sess. p. 122 (1964).

As is normally the case, this report was probably written with the advice of tax experts from the Treasury Department and reflects their views. Writers in the field unanimously understood that no accrual was required, or even permitted. Even the law review article cited by the Government (Br. 40 n. 37) for its proposition sets forth "* * *

(Continued from preceding page)

basis for determining gain or loss on their sale or redemption (O. D. 726, C. B. 3, 49), any profit realized being a profit resulting from the conversion of a capital asset and any loss sustained being deductible."

⁴⁰ Nor is it significant that the rulings do not speak in terms of constitutional limitations in view of the Treasury's longstanding opposition to the exemption.

the Federal rule that neither premium nor discount on bonds is to be amortized by the purchaser."⁴⁷

Close examination of the Government's brief and the authorities cited in it reveals nothing contrary in regard to investors. It cites and promptly dismisses as incorrect, O. D. 475, 2 Cum. Bull. 211 (1920), which established the rule that discount could not be accrued, and *Corn Exchange Bank v. Commissioner*, 6 B. T. A. 158 (1927), the landmark case, where the Treasury succeeded in preventing a bank acting as an investor from amortizing either discount or premium. There the court said (pp. 161-162):

"We think, however, that no accrual can be predicated on the premium or discount at which a bond is purchased before the bond is sold or redeemed. Before sale or redemption of a bond nothing occurs to fix the amount which the holder thereof will actually realize from it.

* * * * *

"The same consideration governs in determining the proper basis to be employed in computing gain or loss on the sale of the bonds under the 1921 Act as under the 1913 Act. The basis prescribed by the

⁴⁷ Brandis, *Effect of Discount or Premium on Bondholder's North Carolina Income Tax*, 19 No. Car. L. Rev. 1, 4 (1940), cited at Br. 19, 40 (as corrected) as "*Effect of Discount or Premium*." Other writers are equally clear. Mertens, for instance, says at Ch. 23, Section 23.162, p. 298 n. 31:

"The Code is silent as to how discount on bonds purchased is treated for tax purposes. The established rule is, however, that the basis for determining gain or loss on disposition of the bond is the amount paid therefor. No part of the discount can be treated as income pro-rated over the life or term of the bond."

See also Paton, *Advanced Accounting* (1941) p. 196; *Accountant's Handbook* (2d ed. 1939), p. 339; Newlove, *Intermediate Accounting* (1939 ed.), p. 205; Lawrence, *Bond Discount Treatment Under the 1942 Revenue Act*, 21 Taxes 651 (1943).

statute for computing gain or loss is cost. * * * Unlike depreciation, the annual amortization of premium or discount on securities of other corporations held for investment is not an allowable adjustment to income, nor an allowable adjustment to the basis for computing gain or loss on sale. See *Appeal of Even Realty Co.*, 1 B. T. A. 355."

The Government seeks to minimize the impact of this case by pointing out that the Board nowhere says explicitly whether original issue discount or market discount bonds were involved. But the opinion does seem rather clearly to deal with all the bonds in the Bank's investment portfolio and it is difficult to imagine that both types of discount and premium would not be involved in the portfolio of such a bank.⁴⁸

In an attempt to establish a contrary rule, the Government cites three rulings, of which two involved United States obligations as to which statutes in terms treated discount as if it were interest and the third did not involve discount at all.⁴⁹ Beyond this the Government cites only

⁴⁸ As the District Court in the instant case put it: "[A]n examination of both the facts and the opinion in the Corn Exchange Bank case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transactions involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved." 214 F. Supp., at 636 (R. 25).

⁴⁹ T. D. 3301, 1-1 Cum. Bull. 100 (1922), dealt with Treasury Savings certificates issued under a statute which in terms described the excess of the face amount over the purchase price as "interest to maturity" and G. C. M. 15875, XIV-2 Cum. Bull. 100 (1935), as the Government itself admits, dealt with United States Savings Bonds issued under a statute which specifically provided that the discount "shall be considered as interest."

Finally, I. T. 1684, II-1 Cum. Bull. 60 (1923), seems to have involved a redeemable bank deposit upon which interest or dividends were credited annually, but which, if left on deposit for a sufficient time, would double in value. Since neither discount nor gain are even mentioned in the ruling, it is difficult to see how it is relevant to the present issue. See I. T. 2924, XIV-2 Cum. Bull. 135 (1935) for a fuller explanation of what seem to be the facts.

cases and rulings dealing with permissible accounting methods for commercial loan departments of financial companies.⁵⁰ Since none of these authorities concerns either capital assets (because the taxpayers were in the business of dealing with these obligations) or sales or exchanges, it is difficult to see their relevance.

The short of the matter is that the Government has established the existence of a permissible accounting method applicable to the unique circumstances of a commercial lender holding discount loans in the regular course of its business, and has misconstrued this as establishing a general rule applicable to discount under all circumstances.

While the treatment of discount in other situations does not have the relevance which the Government implies, it should be pointed out that under most circumstances discount has been treated differently from interest. For instance, the deduction of discount has been held not to be subject to a statutory limitation on the deduction of interest. A. R. R. 880, I-1 Cum. Bull. 276 (1922). Similarly it has been held that discount does not qualify as interest paid for the purpose of computing a life insurance company reserve interest credit. *Standard Life Insurance Co. v. United States*, 62-1 U. S. T. C. para. 9404 (S. D. Ind. 1962).

The Government's brief itself devotes two pages (Br. 18-20) to a discussion of whether market discount ought to be treated as it says original issue discount should be

⁵⁰ *Chatham & Phenix National Bank v. Commissioner*, 1 B. T. A. 460 (1925) (bank); S. M. 3820, IV-2 Cum. Bull. 32 (1925) (bank); *Chicago Acceptance Co. v. Commissioner*, 12 B. T. A. 150 (1928) (finance company); *Vancoh Realty Co. v. Commissioner*, 33 B. T. A. 918 (1936) (finance company); *Motors Securities Co., Inc. v. Commissioner*, decided October 30, 1952 (P-H Tax Ct. Mem. Dec. Para. 52,316) (finance company).

treated, or continued to be recognized as capital gain when realized, as finally the Government admits it must be. The Government attempts no argument that ordinary market discount is anything other than compensation for the use of money. The fact that the compensation is received by the investor from someone other than the borrower is wholly immaterial; certainly interest on an ordinary interest bearing note paid by someone other than the maker could not be excluded from the noteholder's income.

As the Government also well recognizes (Br. 20-21), the purchase of property on a deferred payment basis at a stated price higher than would have been exacted if a cash payment had been made involves compensation for the use of money payable by the buyer of the property to the seller of the property, in exactly the same sense that debt discount involves compensation payable by the borrower to the lender. Yet the Treasury Department does not assert, and courts do not hold, that any part of the payments received by the seller should be considered as interest income except as the interest element is separately identified. It appears from the Government's discussion that in this instance it is content to let Congress' legislative solution of the matter, which was finally determined upon only in 1964, be given the prospective effect which Congress intended.

Moreover, application of the Government's theory to § 1232 of the 1954 Code would remove the limitations carefully prescribed by Congress. This statute applies only to corporate obligations, only if the obligation has been held for more than six months⁵¹ and only if the dis-

⁵¹ In cases where taxpayers have other capital losses which would be deductible only against capital gain, whether long or short term, this distinction is most important, since under § 1232 gain from the sale of obligations held less than six months is a short term capital gain.

count rate is greater than $\frac{1}{4}$ th of 1% per annum. It does not apply at all if the particular holder has paid a premium. The Government's theory, which requires discount to be treated as interest for tax purposes and to be accrued on a daily basis, on the other hand, must apply to discount in any amount on obligations issued by any taxpayer and regardless of holding period or cost to the holder. Further, the whole concept of Section 1232 and its very language assumes that the discount realized by sale or redemption is part of the gain on the disposition of the note—not income accruing during the period the note was held as the Government now asserts.

Obviously the Government's theory and the Congressional enactment cannot stand together. If the Government believes that the provisions of the 1954 Code have not yet properly provided for ordinary income treatment of original issue discount it should present its arguments to the Congress, not to this Court.

The statement of the Court in *Hanover Bank v. Commissioner*, 369 U. S. 672, at 682, is particularly apt here.

"The Government's primary reason for urging this interpretation of Section 125 is that the statute has created a tax loophole of major dimension that should be closed short of allowing the deduction sought in this case. While this assertion might have been persuasive in securing enactment of the amendments to the statute made subsequent to the time the transactions involved here took place (see discussion, *infra*), it may not, of course, have any impact upon our interpretation of the statute under review. We are bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history. In neither do we find support for the Government's interpretation."

Presumably the Treasury's similar assertions that discount is, in some cases, economically the equivalent of interest were persuasive in securing the enactment of Section 1232 of the 1954 Code. They should not be persuasive in securing retroactive application to this case of that provision, or of some substitute principle said to produce the same or a better result.

CONCLUSION.

For the reasons stated, the judgment of the Court of Appeals for the Sixth Circuit should be affirmed.

Respectfully submitted,

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